# Monetary Crisis...

It has been well over twenty five years that banking experts indicated the benefits of spreading their credit risks through the banking sector in the same way as the insurance companies spread their risks by reinsuring their risks through the insurance market. After overhearing these remarks I never heard or read anything about the analogy as the banking sector went through its own developments of assuming risks in the financial markets and how to obtain the necessary funding hereto. Close attention was also directed to their vigorously expanding role of intermediating between lenders and borrowers in the financial markets where money and savings are channeled for investments purposes only and for the financing of goods, services and innovation. Globalization of course became the important trend that played in where banking institutions, meaning commercial as well as investment banking, became increasingly operational on a global basis together with their clients, those transnational commercial entities which on their turn were already outsourcing their production, services and sales capacity around the world.

The financial instruments through which the financial sector transfers the private sector and sovereign liquidity and savings on behalf of the real economy on a worldwide basis, became more and more complicated as among others, currency- and interest swaps, options, securitization of assets, asset backed securities, derivatives etc., were widely applied to make this transfer process of international financing and investing feasible. All the while the financing and investment risks on a micro basis were thought to be under control and of no harm as long as the credit and investment risks were spread through mentioned instruments across the whole of the financial and investment sector. The thinking was that the risks were sufficiently reduced. Take for instance individual mortgages that were split up and securitized in multiple mortgage backed assets and hence spinned-off all over the market. The financial instruments that facilitated the spread were thought to be shockproof against loan delinquencies on a micro basis and thus no spillover from micro to macro positions were to be feared. Another factor playing in was the importance of fee income in the market. Loan facilities were booked, split up and spinned-off all the while giving more importance to fee income next to interest income which is especially the case with the investment banks like Lehman Brothers, Merrill Lynch and J.P. Morgan which institutions next to keeping large portions of underwritten loan facilities on their books, also played an increasingly important role in the market in brokering between borrowers and lenders. The extreme situation is to be found at the mortgage banks where mortgage loans were facilitated to the private sector with high delinquency probabilities factored in.

The securitization process also became instrumental in raising new funding in the market through (asset backed) bond issues especially, in order to again package and securitize new credit arrangements with new and replenished cash positions; note the importance of fee income herein. In the end long-term loans were short-term financed as the bonds issued were of a much shorter duration than the outstanding loan packages. Thus a normal mortgage loan for instance became susceptible to money market interest changes like the Fed funds rate. The consequences of these adjustable mortgage rate facilities are very well known.

In addition mass consumption has been financed for years at macro economic proportions on the rationale of existing margins in the home equity concept that allowed for additional consumer credit lines due to stable and increasing housing values. When the Fed started increasing the Fed funds rate in order to stem an overheated economy and inflationary expectations, the mortgage rates were adjusted accordingly resulting in massive repayment delinquencies. As the micro field had been obscured through the spreads, the market was confident that the financial asset backed instruments were sufficiently shockproof to absorb disturbances in the housing market. The continuing delinquencies made the housing market collapse whilst during the process all related and interdependent sectors were dragged along including most importantly consumer spending on a national basis. Both the collapse of the housing market in combination with the collapse of consumer spending on a national basis reached macro economic proportions adversely affecting the US economy in its totality and through international interdependence and interrelation the rest of the world economy is affected as well. The severe intensity and mega multiplier effects which started to manifest themselves throughout the US and the world economy were certainly not foreseen nor anticipated at such a magnitude.

De facto long-term assets were financed by short-term funding but apart from this monetization of long-term assets the US budgetary deficit was on the rise whilst the war on terror in the end cost US dollar 10 billion a month adding to an already over liquid market. Over liquidity was first a result of offsetting and countering downward business cycles (which so it seems are no longer politically acceptable) by adjusting the money market rates thus making money cheaper to stimulate the economy but also making money excessively available.

Some will remember the Vietnam war which was financed through money creation as well. A substantial overhang of excess dollars, the Euro dollar market was the result with collapsing fixed exchange rate systems and successive devaluations of the US dollar. Again a similar overhang of liquidity apart from pressuring the dol-



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lar downwards is the origin that feeds the existence of macro bubbles such as the US housing bubble where housing prices are excessively inflated.

Fiscal policy with repetitive tax cuts benefiting the capital rich sector as a stimulus to investments added to the unstable behavior of the financial markets. Hedge funds which handle and intermediate in this sector showed unstable and distorting capital market behavior by short-term investments which were meant to generate quick profits and excessive yields, thus distancing investments more and more away from the real economy with dislocating effects on the mix of production, services and innovation factors.

The resulting implosion of the US housing and consumer markets caused an unimaginable deflation of the housing bubble and the rest of the economy. The drastic downfall of demand for housing and consumer spending together with mentioned intensive and mega multiplier effects led to unbelievable write-offs of related assets in the financial markets which all but wiped out the entire financial sector. Funding and equity evaporated through the markets thus forcing central banks to pour in liquidity and funding whilst equity positions were taken also by government in order to prevent a collapse of the financial system. Trust also evaporated and the financial system remained dysfunctional ever since, the credit markets stopped functioning. Other sectors such as insurance, retail and auto industries followed. Newly introduced fiscal policies are aimed at boosting and at least try to maintain consumer demand. Trust seems to be regained however albeit at a very slow pace as confidence walks in by foot where it fled away by a stampeding and very fast horse, so the saying goes. Meanwhile through the disconnect (no transfers of liquidity and capital from financial sector to the real economy) between the financial markets and the real economy combined with a dismal consumer demand, the real economy is suffering dearly with unemployment sharply rising, reduced consumer demand with the mega multipliers operating at full force and central bank with government trying to position themselves in front of the economic curve rather than reacting only when dismal economic signals pop-up. Whether this combined action of massive monetary and fiscal policy, will do the job remains an open question, there are signs of a slight recovery of confidence at least in the equity markets. Investments propulsions and incitements may be stimulated by government induced incentives in green energy, education, innovation, research and development, revival of middle class existence, revised health programs, overhauled transport means, reconstruction of infrastructure such as roads, bridges, airports etc. all providing an open infrastructure with fresh opportunities for capital formation and employment and restored income.

The financial sector will need to restore their equity and reserves at much higher levels than before in order to sustain the dismal vicissitudes which go along with the new age financial instruments, improved mandatory liquidity ratios will have to go along as well. Combined equity positions of government and private sector in the financial world probably will exist for the time being, until trust and proper supervision by central banks have found their way back to sound and effective levels.

Small scale and lob-sided economies in the Caribbean are at particular risk where services will be affected seriously by decreasing tourism visits and tourism spending. Especially governments that produce eternal and increasing budget deficits are in danger. Misallocations of production and services factors and under performance by government in collectively produced services and products (education, infrastructure, economic development, health services etc.) and low levels of national productivity and non- transparency are the usual signs and distinguishing marks of such economies. Government revenues will decline sharply whilst expenditures will remain persistent at the same levels. Deficits will increase with government applying for more borrowings on local capital markets and increased interest expenditures resulting thereby in crowding out private sector on its high interest capital markets as international markets will not be willing to finance for the time being. Increased taxes and collective premiums together with locally induced inflationary pressures will further deplete and reduce income whilst employment may be severely affected with increased crime rates as a result. F

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